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No. ____

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1981

FEDDERS CORPORATION AND SUBSIDIARIES,
*Petitioners,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

ON PETITION FOR WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

## PETITION FOR WRIT OF CERTIORARI

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## QUESTION PRESENTED FOR REVIEW

1. Does a company which acquires a business which has no excess earnings capacity also acquire goodwill for purposes of the federal income tax laws? There is a conflict among the circuits with respect to this issue.

## LIST OF PARTIES AND LISTING PURSUANT TO RULE 28.1

All parties to the proceeding in the court whose judgment is sought to be reviewed were:

Fedders Corporation*
Fedders Financial Corporation
Fedders Center, New Orleans, Inc.
Warren-Connolly Co., Inc.
Fedders Center, Inc.
Fedders Center, Chicago, Inc.
Fedders-Norge Distributors of New Orleans, Inc.
Fedders-Norge Distributors of Chicago, Inc.
Fedders Puerto Rico, Inc.
Fednor Corporation
RMR Corporation
Fedders Oklahoma, Inc.

*Petitioners-Appellants*

and

Commissioner of Internal Revenue

*Respondent-Appellee*

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* Fedders Corporation is the parent corporation of the other petitioners. The petitioners have no other parent corporations, subsidiaries or affiliates except Fedders Corporation, and its wholly-owned subsidiaries hold minority interests in the securities of other corporations.

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*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

## REFERENCE TO OPINION BELOW

The Memorandum Findings of Fact and Opinion of the United States Tax Court which was adopted by the United States Court of Appeals for the Third Circuit and upon which the judgment sought to be reviewed was rendered is reported at 39 TCM (CCH) 1.

## STATEMENT OF GROUNDS OF JURISDICTION

(i) The judgment sought to be reviewed was entered on April 16, 1981.

(ii) N/A

(iii) N/A

(iv) This Court has jurisdiction to review the judgment in question by writ of certiorari pursuant to 28 U.S.C. §1254(1) (1976).

## STATEMENT OF THE CASE

### *A. Basis for federal jurisdiction alleged in the court of first instance.*

The Tax Court had jurisdiction, pursuant to 26 U.S.C. §6213, over Fedders' petition to redetermine the deficiency assessed by the Commissioner of Internal Revenue.

### *B. Introduction*

This Petition involves a widespread problem which necessarily occurs in every business acquisition, *i.e.*, whether the acquisition resulted in the transfer of any goodwill for federal income tax purposes to the acquiring company. As we will show, the state of the law in this area, which includes a conflict among the circuits, is such that there is no definition of goodwill which is consistently applied by the courts. The present case clearly demonstrates this confusion. The courts below specifically held that the Petitioners Fedders Corporation and Subsidiaries ("Fedders") had *not* acquired any goodwill according to one common legal standard. Nevertheless, the Tax Court and the Court of Appeals then went on to apply a totally different and inconsistent standard so as to conclude that Fedders acquired intangibles worth $4.5 million. This resulted in a serious injustice to Fedders which was thereby saddled with an additional tax liability in excess of $6 million including interest. Fedders, however, is only one example of the numerous cases in which this type of injustice has arisen or is likely to arise. A decision of this Court is, therefore, necessary to create uniformity in the law so as to eliminate the anomalous situation which exists at the present.

### *C. Statement of Facts*

This case involves the determination of the federal income tax consequences of the purchase by Fedders on July 1, 1968 of certain assets of the Norge Division ("Norge") of Borg-Warner Corporation ("Borg-Warner"). Norge was a manufacturer of "white goods", *i.e.*, major kitchen and laundry appliances.

Fedders calculated its income taxes without reducing the values of any of the Norge assets on account of claimed goodwill,

going concern value, or any other intangible allegedly relating to those assets. Fedders' position that the Norge assets had no such value is consistent with the acquisition agreement between Fedders and Borg-Warner (the "Agreement") (*e.g.*, A 671, 689).* Fedders treated the Norge assets as having the same tangible values for tax and financial reporting purposes (A 180, 700). These values are also consistent with the values the parties reflected in the Agreement (A 689). Borg-Warner, on the other hand, claimed for tax purposes that the assets sold to Fedders included intangibles allegedly worth $45 million. Borg-Warner's tax returns allocated the purchase price paid by Fedders ($45,213,255) to each category of assets and intangibles, concluding that $22,171,068 of the purchase price was for Norge intangibles. In so doing, Borg-Warner deliberately and consciously took advantage of the confusion in the law regarding goodwill. Thus, the record in this case makes clear that Borg-Warner, as its own chairman testified at trial, thought that Norge had no goodwill (and, indeed, had negative goodwill due to poor product quality). Nevertheless, Borg-Warner claimed on its tax returns that Norge had substantial goodwill, in the expectation that the Commissioner would pursue Fedders, which would have the large "deficiency" as a result of not declaring the acquisition of goodwill on its tax returns (A 598-600, 708-10).

The Respondent, Commissioner of Internal Revenue ("Commissioner"), took inconsistent positions with respect to the parties' tax treatment of the transaction. Thus, the Commissioner essentially applied Borg-Warner's treatment to Fedders' tax returns and Fedders' treatment to Borg-Warner's tax returns (A 25-64). In so doing, as to Fedders, the Commissioner reduced the cost basis of the assets acquired by Fedders below the values agreed upon by the parties, thus artificially increasing the amount of taxable income realized on the current assets and reducing the depreciation deductions for the fixed assets (A 25-64). As a result, the Commissioner assessed a deficiency of $14,903,769 against Fedders attributable to the claimed Norge

* The abbreviation "A" refers to pages of the Appendix in the Court of Appeals, which has been requested to be certified and transmitted pursuant to Rules 19.1 and 19.2 of the Rules of this Court.

intangibles, consisting of $7,606,217 for Fedders' tax year 1968, $6,970,209 for tax year 1969, and $327,343 for tax year 1970 (Derived from Notice of Deficiency [ibid.]).

Both Fedders and Borg-Warner petitioned the Tax Court for redetermination of their respective alleged deficiencies, and the two proceedings were consolidated. At the trial, the Commissioner asserted that he is merely a stakeholder, and that his only interest is to make certain that the transaction is treated consistently for tax purposes by both parties. He specifically refrained from taking any position on the merits of the dispute (*e.g.*, A 123-24).

### *D. The Decision of the Courts Below*

After a full trial on the merits, the Tax Court issued a detailed Memorandum Findings of Fact and Opinion (App. 3a-42a).* In this Memorandum, the Court made numerous specific findings of fact relating to the poor and unprofitable nature of Norge's business and operations prior to the acquisition, as well as the extensive efforts which Fedders was required to conduct after the acquisition in an attempt to make the Norge business profitable. These fact findings are fully supported by the record; they are not in dispute in this Petition, nor were they in dispute in the Court of Appeals.

The Tax Court recognized in its Opinion that applicable case law with respect to the existence of goodwill requires "the expectation of continuing excess earning capacity and some competitive advantage or continued patronage" (App. 29a). As a result of its fact findings the Court came to the inevitable conclusion that "Norge had no goodwill in the sense of excess earnings capacity" (App. 30a) and, indeed, that "the picture of Norge that emerges from the record is a company that, since World War II, was unable consistently to earn a profit except under the exceptional managerial leadership of Judson Sayre" (App. 29a-30a).

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* The abbreviation "App." refers to pages of the Appendix to this Petition, *infra*.

Having found that by utilizing one of the applicable legal standards Norge had no goodwill, the Court then chose another, inconsistent, legal standard in order to find that the Norge name had a value of $4.5 million. Thus, the Court stated that "lack of profitability does not in and of itself prove the absence of intangible value" (App. 30a, footnote omitted).

Based on its Memorandum, the Tax Court assessed deficiencies against Fedders totalling $3,268,677.28 plus interest (A 958). On appeal, the Third Circuit affirmed, based on the Tax Court's Memorandum Findings and Opinion. Thus, the Court of Appeals itself adopted the legal inconsistencies which resulted in the Tax Court's holding.

## ARGUMENT

### The Conflict Among The Circuits With The Resulting Confusion In The Law Requires A Decision Of This Court As To The Definition Of Goodwill

The complete disarray with respect to the legal definition of goodwill for federal income tax purposes is exemplified by the conflict between the circuits regarding this issue. Thus, the "continued excess earnings capacity/competitive advantage" definition was adopted by the Sixth Circuit in *Concord Control, Inc. v. Commissioner*, 615 F.2d 1153, 1155 (6th Cir. 1980), as follows:

> "The Commissioner argues that the Tax Court erred in finding that no goodwill was purchased in 1964. The Commissioner contends that the Tax Court committed an error of law by requiring an expectancy of continued customer patronage or competitive advantage in addition to excess earnings over the normal industry average to establish the existence of goodwill. No Court has adopted the Commissioner's position and there is ample authority to the contrary."

On the other hand, the Third Circuit in the present case, by adopting the Opinion of the Tax Court, has held that goodwill can exist even in the absence of profitability, let alone excess earnings capacity.

Furthermore, the Fifth, Seventh, Ninth and District of Columbia Circuits have held that goodwill consists *only* of the expectancy of continued patronage, *e.g., Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973); *Karan v. Commissioner*, 319 F.2d 303 (7th Cir. 1963); *Commissioner v. Killian*, 314 F.2d 852 (5th Cir. 1963); *Boe v. Commissioner*, 307 F.2d 339 (9th Cir. 1962); *Burke v. Canfield*, 121 F.2d 877 (D.C. Cir. 1941).

This conflict between the circuits is reflected in various opinions of the Tax Court. Thus the "continued excess earnings capacity/competitive advantage" definition has been adopted in recent cases in that Court. In *VGS Corp.*, 68 T.C. 563, 590 (1977) "goodwill" was defined in the following terms:

> "To support a finding that goodwill was transferred, it is necessary that the business was such that the purchaser could expect not only continued excess earning capacity but also some competitive advantage or continued patronage; i.e., the expectancy that old customers satisfied with the quality of services or product would return" (68 T.C. at 590).

Similarly, in *Wilmot Fleming Engineering Co.*, 65 T.C. 847 (1976), the Court held that:

> "Focusing on the character of the partnership business, we do not accord much significance to the face of the partnership's profitability; high earnings per se do not constitute goodwill. *Estate of Leopold Kaffie*, 44 B.T.A. 843 (1941); Donal A. Carty, 38 T.C. 46 (1962); *Estate of Henry A. Maddock, supra;* A. T. Miller, 39 T.C. 940 (1963), affd. 333 F.2d 400 (8th Cir. 1963). More important is the question whether the business was such as to provide its purchaser with the expectancy of both continuing excess earning capacity and also of competitive advantage or continued patronage" (65 T.C. at 860-61).

And, in *Concord Control Inc.*, 35 TCM 1345 (1976), §76,301 P-H Memo TC (1976), *aff d*, 615 F.2d 1153 (6th Cir. 1980), the Court held that:

> "A precondition to the possession of transferable goodwill is a finding that the seller's business is of such a nature as to provide the purchaser with the expectancy of both continuing excess earning capacity and competitive advantage or continued patronage. *Wilmot Fleming Engineering Co.*, 65 T.C. 847, 861 (1976). Excess earning capacity in and of itself is insufficient to demonstrate the transfer of goodwill." (35 TCM at 1356, §76,301 P-H Memo TC at 76-1333.)

Indeed, as we have seen, the Tax Court in the present case recognized the validity of this definition.

On the other hand, the Tax Court in *Computing & Software, Inc.*, 64 T.C. 223 (1975), agreed with the definition adopted by the Fifth, Seventh, Ninth and District of Columbia Circuits, to the effect that goodwill consists only of the expectation of continued customer patronage. *Accord, C.F. Hovey Co.*, 4 B.T.A. 175 (1926). And, in *Buddy Schoellkopf Products, Inc.*, 65 T.C. 640 (1975), the Tax Court held that a company which had not been operated at a profit and which had lost much of its reputation, nevertheless had goodwill due to the existence of its trade name.

From the foregoing, the only thing that is clear is that there is no definition of goodwill which has been uniformly or consistently applied by the federal courts. This is a serious problem, which only this Court can resolve. That a uniform and consistent definition of goodwill for federal income tax purposes is a major issue which should be resolved by this Court is self-evident. The question of what constitutes goodwill inevitably arises in *every* business acquisition. It is necessary for the parties to such acquisitions, as well as the Commissioner, to know what the law is in this regard, particularly since substantial sums of money are usually involved.* The present state of the law creates uncer-

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* In the present case, the deficiency asserted by the Commissioner against Fedders, including interest, came to in excess of $20 million. The deficiency assessed by the Tax Court, including interest, is in excess of $6 million. The net worth of Fedders as reported as of October 31, 1980 is only approximately $25 million.

tainty in business dealings, and promotes litigation. Parties should not be required to act at their peril with their substantial rights determined by the fortuitous circumstance of which circuit ultimately hears their case. A clear legal standard is needed, and only this Court can provide it.

## CONCLUSION

For the foregoing reasons, Petitioners pray that this Court issue a writ of certiorari to review the judgment of the Court of Appeals for the Third Circuit.

Respectfully submitted,

JOHN B. SHERMAN
*Attorney for Petitioners*

Weisman, Celler, Spett,
Modlin & Wertheimer
*Of Counsel*

# APPENDIX

# UNITED STATES COURT OF APPEALS
# FOR THE THIRD DISTRICT

Nos. 80-2257 and 80-2258

FEDDERS CORPORATION and Subsidiaries,
*Appellant in No. 80-2257*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Appellant in No. 80-2258*

On Appeal From the United States Tax Court
T.C. No. 060533-75

Argued March 23, 1981
Before HUNTER, SLOVITER, and WISDOM,* *Circuit Judges,*

## JUDGMENT ORDER

After consideration of all contentions raised by appellants, it is

ADJUDGED and ORDERED that for the reasons set forth in its opinion, T.C. Memo 1979-350 (Sept. 4, 1979), the judgment of the Tax Court be and is hereby affirmed.

Costs taxed against appellants.

By the Court

JAMES HUNTER, III, *Circuit Judge*

Attest:

Sally Mrvos, *Clerk*

*Date: April 16, 1981*

* Honorable John M. Wisdom, United States Circuit Judge for the Fifth Circuit, sitting by designation

# TAX COURT'S MEMORANDUM FINDINGS OF FACT AND OPINION

T.C. Memo. 1979-350

## UNITED STATES TAX COURT

FEDDERS CORPORATION and Subsidiaries,
*Petitioners,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

BORG-WARNER CORPORATION,
*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

Docket Nos. 6053-75, 6476-75. Filed September 4, 1979

*Lawrence N. Weiss*, for the petitioners in docket No. 6053-75.

*Joseph E. McAndrews, Nora A. Bailey*, and *Neal F. Farrell*, for the petitioner in docket No. 6476-75.

*Marwin A. Batt*, for the respondent.

## MEMORANDUM FINDINGS OF FACT AND OPINION

TANNENWALD, *Judge:* Respondent determined the following deficiencies in petitioners' Federal income tax:

| *Docket No.* | *Year Ended* | *Deficience* |
|---|---|---|
| 6053-75 | August 31, 1968 | $7,606,216.89 |
| | August 31, 1969 | 7,141,349.10 |
| | August 31, 1970 | 557,506.00 |
| 6476-75 | December 31, 1968 | 6,316,749.57 |

The primary issue for our decision is the allocation of the purchase price paid by Fedders Corporation for Borg-Warner Corporation's Norge Division. The resolution of this issue depends, in part, upon whether petitioners made a bona fide allocation of the purchase price in their sales contract and upon whether any intangible assets of value were sold to Fedders. If we determine that Fedders acquired valuable intangible assets, we must then decide whether such assets were abandoned, thus giving rise to an abandonment loss. Also at issue is whether Borg-Warner is entitled to a worthless stock loss under section 165(g)(3)[1] for stock in its subsidiary, Warren-Connolly Company.[2]

## FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulations of facts and attached exhibits are incorporated herein by this reference.

The petitioner Fedders Corporation (Fedders) is a New York corporation and had its principal office at Edison, New Jersey, at the time of filing the petition herein. It filed its Federal income tax returns as consolidated returns on the accrual basis on behalf

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years at issue, unless otherwise indicated.

[2] In their petition, Fedders and its subsidiary, Fedders Financial Corporation, claim entitlement to deductions for accrued state taxes in excess of the amount allowed by respondent and Fedders claims entitlement to a deduction for repair expenses that respondent determined must be capitalized. Fedders introduced no evidence at trial and made no arguments on brief with respect to these issues. Further, Fedders stated on brief that it would not "add to the Court's burden by making a point as to * * * other issues." Accordingly, we conclude that Fedders has conceded these issues. In any event, we would hold for respondent on these issues on the ground that Fedders has failed to carry its burden of proof. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a), Tax Court Rules of Practice and Procedure.

Fedders also states on brief that there are other issues that are affected by our determination of the proper allocation of the purchase price and suggests that these can be resolved in connection with the Rule 155 computation. We admonish Fedders that proceedings under Rule 155 are strictly limited to consideration of the correct computation of the deficiency and no further argument will be heard on issues decided herein or on new issues. *Bankers' Pocahontas Coal Co. v. Burnet*, 287 U.S. 308 (1932); *Estate of Stein v. Commissioner*, 40 T.C. 275, 280 (1963); Rule 155(c), Tax Court Rules of Practice and Procedure.

of itself and its subsidiaries for the years at issue with the office of the Internal Revenue Service at Philadelphia, Pennsylvania.

The petitioner Borg-Warner Corporation (Borg-Warner) is a Delaware corporation and had its principal office at Chicago, Illinois, at the time of filing the petition herein. It filed its original Federal income tax return for 1968 and an amended return on the accrual basis with the office of the Internal Revenue Service at Chicago, Illinois.

Fedders and Borg-Warner are unrelated publicly-owned corporations whose stocks are traded on the New York Stock Exchange. On July 1, 1968, Borg-Warner sold its Norge Division (Norge) to Fedders for $45,213,255, its net book value. Payment was made with $20 million in cash, a negotiable subordinated promissory note in the face amount of $13,213,255, with interest at 7 percent, maturing in 1980, a non-negotiable promissory note in the face amount of $3,600,000, with interest at 7 percent, maturing in 1969, and 210,000 shares of Fedders common stock, $1.00 par value, with a total market value of $8,400,000. Additionally, Fedders assumed certain liabilities of the Norge Division.

Borg-Warner is a diversified manufacturer, which is engaged primarily in the production of chemicals and plastics, builder and consumer products, industrial equipment, specialty steels, and automotive equipment. Until it sold its Norge Division to Fedders, Borg-Warner, through that Division, manufactured and marketed a line of "white goods" appliances, consisting of home laundry equipment and gas and electric ranges, and commercial laundry and dry cleaning equipment. The Norge Division also marketed refrigerators, freezers, dishwashers, food waste disposals, water heaters, and ranges manufactured by others. In addition, the Norge Division manufactured and marketed room air conditioners.

With the exception of private label sales (sales to retailers who market products under their own names), Borg-Warner sold its white goods appliances under the Norge brand name. It sold its room air conditioners under the names "Norge" and "York." Although these products, and advertising with respect to them,

sometimes bore the trademarks "Borg-Warner" or "BW," the Norge Division did not advertise or promote the Norge name with either of these trademarks other than in a manner which showed that Norge was a division of Borg-Warner and that Borg-Warner had financial responsibility for the Division. Norge products were marketed outside the United States, under the Norge name, through Borg-Warner International Corporation, a subsidiary of Borg-Warner.

The Norge Division had been operated by Borg-Warner since 1929, when Borg-Warner acquired Detroit Gear, which at the time manufactured refrigerators under the Norge name. From the time of its acquisition by Borg-Warner until World War II, the Norge Division operated successfully. It manufactured one of the first plug-in types of refrigerators. Around 1936, it was second only to the Frigidaire Division of General Motors in the sale of refrigerators. After World War II (during which it engaged entirely in the production of war products), Norge returned to the appliance business. In order to meet competition, it quickly put into production a freon compressor for refrigerators to replace the sulphur dioxide system it had manufactured before the War. Norge had not concentrated on developing the new compressor prior to the War and it was not sufficiently tested before being marketed. It was defective and resulted in many refrigerator failures. The Norge Division spent aproximately $16 million to fulfill its commitments under warranties by replacing defective refrigerators and parts. Norge also redesigned the defective compressor. Largely because of these expenditures, Norge was not profitable during the period 1949-1952.

In the early 1950's, the Norge Division developed new products, primarily automatic washers and dryers, and thereby expanded its product line beyond refrigerators. However, in the opinion of Borg-Warner's board of directors and top management, the Norge Division lacked the type of management required to effectively merchandise its white goods appliances. In order to solve this problem, in 1954 Borg-Warner hired Judson S. Sayre to serve as president of the Norge Division. Mr. Sayre had a long, successful history in the white goods appliance business and had acquired the reputation in the industry of

being the "father of the automatic washer" because of his very successful efforts to manufacture and market this product as president of the Bendix Corporation.

Mr. Sayre served as president of the Norge Division from 1954 to 1960, and during this period, Norge was very successful in increasing sales and profits. These increased sales and profits resulted from increased advertising, increased research and development for new products, improvements in product design, improvements in manufacturing and marketing procedures, and changes in personnel at the manufacturing and distribution levels. During Mr. Sayre's tenure as president of the Norge Division, the Division invented a dry cleaning machine, which it merchandised through a franchise operation known as Norge Villages (the sale of coin operated laundry and dry cleaning equipment), and also constructed a modern refrigerator plant in leased premises at Fort Smith, Arkansas, in order to expand refrigerator production.

Mr. Sayre resigned as president of the Norge Division in 1960, although he continued as chairman and chief executive officer of the Division until 1962. During the early 1960's, the Norge Division experienced substantial losses, because of overexpansion of the Norge Village franchising operation, over-capacity in the refrigerator plant at Fort Smith, and poor management. The Norge Village business became oversaturated and there were substantial failures of these franchise operations, which were undercapitalized. Norge, which had financed the franchises, incurred substantial losses in the years 1962 through 1966 because of these failures. In addition, although it had originally anticipated that it would be able to generate sufficient additional sales to use to full capacity the new Fort Smith refrigerator plant, Norge was unable to do so and, therefore, had unabsorbed overhead costs at this plant. The Fort Smith lease and manufacturing facilities were sold to Whirlpool Corporation in 1966 and Norge began at that time to purchase refrigerators from the Kelvinator Division of American Motors and to market them under the Norge name.

Some members of Borg-Warner's board of directors had always had reservations about the Norge Division. While most

of Borg-Warner's business was of an industrial type, Norge's business was in consumer products, required comparatively higher advertising and selling budgets, and was more dependent upon volume sales to make a profit. Norge had proved unable to earn a rate of return on its investment that compared favorably with other Borg-Warner divisions. Although dissatisfaction among the board of directors was quelled during the years that Mr. Sayre consistently produced profits fo Norge, it came to the fore again when Norge incurred losses in the early 1960's.

In the early 1960's, management actively considered disposing of the Norge business. One alternative considered was a liquidation, but it was rejected because it was estimated that large losses would be sustained on inventories and receivables of the Norge Division in a liquidation. Borg-Warner also considered a merger of the Kelvinator Division of American Motors and Norge into a separate corporation, but the Antitrust Division of the United States Department of Justice did not approve the merger. Borg-Warner had discussions with several other companies during the period 1963–1965 regarding the sale of the Norge Division, none of which progressed to the point of serious negotiations. When none of the alternatives proved attractive, management decided to sell the Fort Smith plant, thereby reducing unused capacity, to employ new management in an effort to make the Norge Division profitable, and to defer a decision as to its future.

Alonzo B. Kight, who had been president of the Borg-Warner International Corporation and had had experience in merchandising Norge products through that position, was installed as president of the Norge Division in 1965. Mr. Kight's efforts were directed to improving the financial position of Norge. A major innovation during this period was an increase in Norge's private label business, which was principally with Montgomery Ward. Norge's private label business constituted approximately 18 percent of its gross sales in 1966 and 23 percent in 1967.

The sales, pre-tax profit, Federal income and excess profits tax, and net income after tax of the Norge Division for each of the years 1950 to July 1968 were as follows:

| Year | Sales | Net Profit or Loss Before Tax | Federal Income & Excess Profits Tax | Net Income[1] After Taxes |
|---|---|---|---|---|
| 1950 | $ 62,904,862 | $(2,319,785) | — | $(2,319,785) |
| 1951 | 47,448,638 | (9,255,045) | — | (9,255,045) |
| 1952 | 46,438,349 | 998,998 | $ 599,399 | 399,599 |
| 1953 | 43,142,370 | (1,432,929) | 13,229 | (1,446,156) |
| 1954 | 73,769,608 | 4,101,144 | 2,132,595 | 1,968,549 |
| 1955 | 128,966,393 | 11,746,293 | 6,274,472 | 5,471,821 |
| 1956 | 110,966,791 | 7,796,926 | 4,054,401 | 3,742,525 |
| 1957 | 93,418,446 | 5,152,024 | 2,679,053 | 2,472,971 |
| 1958 | 91,394,444 | 4,906,779 | 2,551,525 | 2,355,254 |
| 1959 | 119,695,452 | 9,257,658 | 4,687,986 | 4,569,672 |
| 1960 | 85,333,538 | (1,272,181) | 798,696 | (2,070,877) |
| 1961 | 114,525,678 | 6,961,318 | 3,619,885 | 3,341,433 |
| 1962 | 117,456,385 | 5,401,772 | 2,808,922 | 2,592,850 |
| 1963 | 98,897,106 | (13,749,991) | (6,639,140) | (7,110,851) |
| 1964 | 113,102,477 | (6,687,469) | (3,343,735) | (3,343,734) |
| 1965 | 107,267,876 | (8,598,012) | — | (8,598,012) |
| 1966 | 124,951,484 | 58,658 | 28,189 | 30,468 |
| 1967 | 112,204,718 | 1,008,950 | — | 1,008,950 |
| 1968 (6 mos) | 68,206,185 | 2,066,497 | 1,091,110 | 975,387[2] |

[1] Corporate overhead and debt, which was absorbed by Borg-Warner, has not been taken into account in computing the above figures. The above figures also reflect intercompany profits on sales to Borg-Warner International.

[2] Estimated at 52.8%.

In the ten years preceding the sale of the Norge Division to Fedders, Norge's share of the appliance market declined. With respect to washers, dryers, and refigerators, the decline was more marked in sales under the Norge name while Norge's share of the private label market remained more stable.

Prior to its acquisition of Norge, Fedders was engaged primarily in the manufacture and sale of air conditioning equipment and had an excellent reputation in the air conditioning industry. The majority of its air conditioners were sold by appliance dealers. Fedders felt that appliance dealers were most familiar with the manufacturers of a full line of home appliances and tended to promote these brands more than others. Fedders decided that a full white goods line would give it a marketing advantage and in 1964 decided to expand its business. In 1964, Fedders entered into a supply contract with the Franklin Division of Studebaker Industries for refrigerators, freezers, washers, and dryers. However, this arrangement proved unsatisfactory because Fedders had little control over the production schedules and product quality and found it was unable to sell these products at a competitive price. Fedders decided that it should manufacture its own products and began in 1965 by expanding its plant in Edison, New Jersey, to enable it to produce refrigerators. Fedders invested $7,000,000 in its expanded facilities at Edison. At the time of its acquisition of Norge, production of refrigerators was proceeding in accordance with Fedders' plans, but had not reached a large enough volume to absorb expenses.

In order to accelerate its entrance into the white goods appliance industry, Fedders desired to acquire a company in that field. Fedders negotiated with Studebaker Industries to acquire the Franklin Division, but the negotiations terminated without an acquisition.

Fedders considered Norge an attractive company for its purposes because: (1) Norge sold 150,000 refrigerators annually, but had no manufacturing facility for refrigerators so there would be no duplication of manufacturing facilities for this

appliance; (2) Norge had an established brand name in the home laundry business while Fedders had not begun production; (3) Norge manufactured and sold about 125,000 room air conditioners annually and this operation could be consolidated with Fedders' production; (4) Fedders would acquire existing distribution outlets and manufacturing facilities at less than present day prices; and (5) the combined companies would have prospective sales of 250 to 300 million dollars and savings would result from a merger of sales, advertising, and administrative operations.

When Fedders contacted Borg-Warner, Borg-Warner indicated it would consider selling Norge at net book value and negotiations ensued. At first, Borg-Warner insisted upon receiving the purchase price in cash, but in March or April, 1968, agreed to payment of part of the price with securities and notes.

On July 1, 1968, Borg-Warner and Fedders entered into an agreement, pursuant to which Borg-Warner sold its Norge Division as a going concern to Fedders for a purchase price equal to the net book value of Norge as of June 30, 1968. Borg-Warner agreed to sell and Fedders agreed to purchase the assets and rights relating to the operation of Norge that were listed in the contract, regardless of whether said assets and rights were shown on Norge's audited balance sheet, as agreed upon, for purposes of determining the purchase price.

The following assets and rights were specifically included:

(1) Installments and accounts receivable, inventories, prepayments, deferred items, and fixed assets;

(2) Specified patents (except that Borg-Warner retained a royalty-free nonexclusive license), patent applications, inventories, copyrights, license rights (subject to a royalty-free sublicense in Borg-Warner), and specified trademarks and tradenames together with the goodwill appurtenant thereto;

(3) Drawings, blueprints, specifications, designs, and data prepared by Norge;

(4) Catalogues, brochures, sales literature, promotional material, and other selling material relating to the operations of Norge.

(5) Books of account, records, files, invoices, customers' lists, suppliers' lists, and other data relating to the operations of Norge, except its general ledger;

(6) Rights of Borg-Warner under all contracts, licenses, leases, commitments, sales orders, and purchase orders that Fedders agreed to assume;

(7) All other assets and rights of every kind and nature, real or personal, tangible or intangible, which were owned by and used by Borg-Warner solely in connection with the business of its Norge Division whether or not such assets were reflected in the audited balance sheet, upon which the purchase price was determined, except the assets and properties specifically excluded from the sale; and

(8) Outstanding stock of Warren-Connolly Company, Inc., Norge Appliance & Sales Co. of California, Inc., Norge Appliance & Sales Co. of Florida, Inc., Norge Appliance & Sales Co. of New Jersey, Inc., Norge Appliance & Sales Co. of Pennsylvania, Inc., Norge Appliance & Sales Co. of Texas, Inc., and Norge Appliance Sales & Service, Inc.

The principal trademark specified was "Norge" which was registered in 52 countries. However, "Norge" is the Norwegian name for Norway and, because of its geographical significance, Borg-Warner had had a difficult time registering it in some foreign countries. Exhibits to the agreement included a list of 77 Norge domestic distributors, private label contracts with Montgomery Ward and others, leases, employment agreements, Norge Village franchise agreements, and a list of commercial laundry distributors.

The following assets and rights were specifically excluded:

(1) Cash and securities;

(2) The trademarks and trade names "Borg-Warner" and "B-W";

(3) Accounts receivable due from Borg-Warner, its divisions, and its subsidiaries;

(4) Tax refund claims;

(5) Insurance contracts with certain exceptions relating to products liability insurance;

(6) Inventions, patents, and patent applications (a) in the field of thermoelectrics, (b) in the field of hydrostatic transmission, and (c) covering or relating to any product or process in the developmental stage; and

(7) A claim against Whirlpool Corporation for accrued rents.

The agreement provided that the net book value of Norge would be determined by an audited balance sheet prepared by Peat, Marwick, Mitchell & Co., certified public accountants employed by Borg-Warner, and approved by Arthur Young & Company, certified public accountants for Fedders. A Pro Forma Balance Sheet was attached to the contract and set forth all assets and liabilities that were to be shown on the audited balance sheet.

Peat, Marwick, Mitchell & Co. submitted to Arthur Young & Company the following audited balance sheet:

# NORGE DIVISION OF BORG-WARNER CORPORATION AND WARREN-CONNOLLY COMPANY, INC.

## Combined Balance Sheet
## June 30, 1968

*Assets*

| | | |
|---|---|---|
| Current assets: | | |
| Receivables: | | |
| Notes: | | |
| Trade and customer | | $ 3,101,401 |
| Installment contracts (including amounts due after one year) | | 2,076,183 |
| Accounts: | | |
| Trade and customer | | 19,484,321 |
| Other | | 571,876 |
| | | 25,233,781 |
| Less allowance for doubtful receivables | | 1,450,297 |
| Receivables, net | | 23,783,484 |
| Inventories of finished goods, work in process, materials, and supplies, at the lower of cost (first-in, first-out) or market | | 28,240,205 |
| Prepaid expenses | | 923,496 |
| Total current assets | | 52,947,185 |
| Property, plant, and equipment, at cost | | |
| Land | $ 14,850 | |
| Buildings and land improvements | 6,634,266 | |
| Machinery and equipment | 7,138,177 | |
| Construction in progress | 30,976 | |
| | 13,818,269 | |
| Less accumulated depreciation | 5,366,721 | |

| | |
|---|---|
| Property, plant, and equipment, net | 8,451,548 |
| Deferred charges and other assets, less amortization | 515,055 |
| | 61,913,788 |

*Liabilities and Divisional Equity*

| | |
|---|---|
| Current liabilities: | |
| Accounts payable | 10,590,357 |
| Accrued expenses | 4,104,924 |
| Total current liabilities | 14,695,281 |
| Provision for extended warranties | 1,135,252 |
| Divisional equity contingent liabilities | 46,083,255 |
| | $61,913,788 |

The accounting firms, however, were unable to reach an agreement on all items. The final purchase price was determined by executives of Borg-Warner and Fedders to be $45,213,255, without audit and without resolution of the disputes over specific items. Fedders also agreed to assume liabilities of Norge shown on its audited balance sheet.

The copyrighted materials included in the sale of the Norge Division had no significant value. Because appliance models are modified annually, service and sales training manuals become outdated very quickly.

In the white goods appliance industry, the only patents that are valuable are those that cannot be easily circumvented and that can be licensed to other manufacturers for a royalty. None

of the patents included in the sale of the Norge Division fall within this definition.

The white goods appliance industry consists of the manufacture of washers, dryers, ranges, refrigerators, freezers, and dishwashers. It is a cyclical industry, which is subject to conditions in the housing market, inflation, and money availability. It requires a large capital investment and substantial expenditures for advertising. Because of high overhead, it is difficult to make a profit without a large volume of sales. In the 1960's profits in the industry declined because prices of appliances decreased while costs increased.

A good system of distribution is extremely important in the appliance business. Appliances may be distributed through independent distributors, factory branches, or dealers' buying groups.

Norge marketed approximately 40 percent of its domestic products through independent distributors, a procedure whereby an independent businessman has an exclusive right to sell Norge products to dealers. Independent distributors buy goods from the manufacturer on a nonrecourse basis for sale to dealers, who operate retail stores and sell white goods appliances to the ultimate consumer. The bulk of dealers sell more than one manufacturer's line of white goods appliances, whereas a distributor carries only one white goods line.

In the white goods appliance industry, the independent distributor serves both a warehousing and sales and service function for a manufacturer's products. The distributor supplies inventory, service parts, and service facilities to dealers and finances dealer purchases. The distributor provides a marketing program for the manufacturer's products and employs salesmen to market the manufacturer's line to dealers. The independent distributor is required to have a substantial capital investment at risk in his business to carry inventory, parts and dealer receivables. Expenditures are also required to support a marketing

program, including advertising, sales promotion activities and displays.

Norge marketed approximately 20 percent of its domestic products through eight Norge factory branches. Major appliance manufacturers generally prefer the independent distributor arrangement, which provides an independent relationship with an entrepreneur who has a large investment in inventory and a real profit motive to sell the manufacturer's products. If a manufacturer operates through a factory branch, it has substantial capital requirements to carry inventory until it is sold to dealers, carry dealer receivables, employ managers, salesmen and servicemen, and support the marketing program that must be maintained for dealers. It also has to rely on managers who have no entrepreneurial stake in the enterprise.

Dealers' buying groups are groups of dealers who buy directly from the manufacturer and eliminate the role of the distributor.

A brand name that is widely recognized and that represents a reputation for good performance and durability is an important asset in attracting distributors and dealers. A distributor can generally sell a larger volume and make a greater profit with a good brand name and also usually has fewer service requirements. It is difficult for a manufacturer with a new name to attract distributors and dealers but once a good name is established the distributors and dealers help to maintain it because they usually give the best known brand name the most prominent display space.

It is common in the major appliance industry for white goods appliance distributors to also carry a "brown goods" line (televisions, radios, and stereos). Many of the Norge distributors had strong brown goods lines, Zenith or Motorola, which associations strengthened the distributorships.

A brand name is established aad maintained primarily through advertising and good performance. Brand names are not transferable from one industry to another or from one major appliance to another.

In order to establish consumer awareness of a new brand name in the white goods appliance industry, a company would have to spend about $18 million for advertising over five years, and might spend as much as $8-10 million a year for several years. Once having established consumer awareness, the company would have to continue to spend large amounts in advertising to maintain consumer awareness. However, the fact that consumer awareness has been established does not guarantee that a product will be successful. Performance, reputation, and service are necessary to a successful product.

In the period from 1965 through 1967, average annual traceable advertising (television, magazines, and newspaper supplements) of the top ten major appliance manufacturers was $2,067,000. Borg-Warner spent $859,000, $1,096,000 and $1,043,000 in each of those years, respectively, and ranked eighth, eighth, and seventh, respectively. The average total annual expenditures, including nontraceable advertising, were approximately $3,000,000 in the period 1965-1967.

Approximately 20-25 percent of consumers consult Consumers Union reports before purchasing a major household appliance. Over the years 1960-1968, Norge washers and dryers showed a downward trend in Consumers Union reports. Norge refrigerators maintained a more stable position.

Following the acquisition of Norge, Fedders made major administrative changes. In accordance with plans formulated prior to the purchase, Fedders eliminated duplicative administrative sales and personnel functions by disbanding the Norge headquarters in Chicago and absorbing its functions at Fedders' headquarters in Edison, New Jersey. Within two months, essentially all Norge personnel had been discharged or had left Norge voluntarily.

Prior to the acquisition of Norge, Fedders had not made a detailed investigation of Norge's distribution system and Fedders was disappointed when it took over the operation of Norge.

Borg-Warner had dealt with its independent distributors on an individual basis, granting price concessions, advertising funds, and lenient credit policies to those distributors who demanded or needed such help as a prerequisite to doing business. Fedders felt that these policies placed too great a financial burden on Norge and instituted uniform treatment of all distributors. At least partially because of these changes, Fedders lost 38 out of 77 distributors in the first two years after the acquisition and lost eight more in the third year. These distributorship contracts were cancelled in some instances by Fedders and in others by the distributor.

Fedders also closed seven out of eight Norge factory branches and combined Norge's Chicago branch with Fedders' Chicago branch. Fedders was interested in distributing its products through dealers' buying groups (see p. 25, *supra*) and approached two large buying groups. The groups, however, showed little interest in Norge.

Fedders felt that Norge's dealer structure was very poor and that this made it difficult to obtain distributors. They also believed the lack of dealers diminished the value of consumer advertising because many consumers would not be able to find a dealer from whom they could buy Norge appliances. Therefore, Fedders decided to emphasize advertising in trade publications with the intent of building up demand among dealers. Trade advertising is less expensive than consumer advertising and Fedders spent considerably less on advertising than Borg-Warner had spent.

Fedders encountered problems with the quality of the Norge dryer that had been introduced in May 1968 and in 1969 Fedders retooled. In 1970, Fedders retooled for the Norge washer.

Within a few days of the acquisition, Kelvinator, from whom Norge purchased washers, was sold to White Consolidated

Industries, which increased prices by ten percent. Because of Kelvinator's increased price, Fedders tried to rapidly increase its own production of refrigerators. These efforts resulted in lower quality.

Fedders marketed its appliances under both the Norge and Fedders names. It sold identical air conditioners under both names, charging a higher price for the Fedders air conditioner. For a period in the early 1970's, Fedders used the name "Norge by Fedders," emphasizing the name Norge.

The total dollar volume of appliances sold under the Norge and Fedders names for the years 1969 through 1976 was as follows:

| | Refrigerators | | Freezers | |
|---|---|---|---|---|
| Year | Norge | Fedders | Norge | Fedders |
| 1969 | $14,547,743 | $2,476,841 | $3,955,828 | $246,558 |
| 1970 | 12,887,424 | 336,512 | 4,591,275 | 61,438 |
| 1971 | 21,885,776 | — | 4,477,275 | — |
| 1972 | 17,933,294 | — | 8,123,392 | — |
| 1973 | 15,275,700 | — | 7,579,600 | — |
| 1974 | 1,963,723 | — | 358,065 | — |
| 1975 | — | — | — | — |
| 1976 | — | — | — | — |

| | Dishwashers | Electric Ranges | Gas Ranges |
|---|---|---|---|
| | Norge | Norge | Norge |
| 1969 | $ 690,480 | $1,926,586 | $2,484,736 |
| 1970 | 1,027,876 | 2,468,500 | 2,607,396 |
| 1971 | 1,627,114 | 2,605,630 | 1,963,488 |
| 1972 | 1,887,666 | 2,898,501 | 1,188,506 |
| 1973 | 1,884,114 | 2,844,100 | 1,283,975 |
| 1974 | 686,268 | 218,523 | 297,966 |
| 1975 | 897,339 | — | — |
| 1976 | 626,085 | — | — |

| | Commercial Washers | Commercial Dryers | Commercial Dry Cleaners |
|---|---|---|---|
| | Norge | Norge | Norge |
| 1975 | $1,299,710 | $158,038 | $407,931 |
| 1976 | 1,706,035 | 362,810 | 471,005 |

| | Norge | | | |
|---|---|---|---|---|
| | Automatic Washers | Wring Washers | Electric Dryers | Gas Dryers |
| 1969 | $12,741,246 | $1,641,804 | $3,987,605 | $4,550,700 |
| 1970 | 15,263,690 | 1,292,736 | 4,641,480 | 4,687,850 |
| 1971 | 17,074,224 | 1,526,694 | 5,287,590 | 4,018,014 |
| 1972 | 20,674,452 | 523,068 | 3,883,125 | 3,752,567 |
| 1973 | 15,565,940 | 39,312 | 4,963,872 | 2,865,968 |
| 1974 | 3,603,076 | 79,716 | 1,548,039 | 569,432 |
| 1975 | 28,291,957 | — | 9,464,096 | 3,586,981 |
| 1976 | 38,225,346 | — | 14,077,064 | 5,903,175 |

During the four years following the sale, Fedders expended the following amounts on capital improvements relating to Norge:

| | 8/31/69 | 8/31/70 | 8/31/71 | 8/31/72 |
|---|---|---|---|---|
| Land Improvements | $ 33,515 | $ 28,510 | $ 150,349 | $ 12,369 |
| Land | 100,000 | 129,415 | 11,443 | 29,684 |
| Leasehold Improvements | — | 15,247 | — | — |
| Buildings | 102,358 | 121,647 | 3,272,307 | 62,466 |
| Machinery and Equipment | 347,540 | 1,474,661 | 957,696 | 294,261 |
| Vehicles | 3,200 | — | — | 5,000 |
| Furniture and Fixtures | 5,833 | 18,522 | 12,545 | 6,133 |
| Jigs and Dies | 237,937 | 1,044,839 | 2,097,893 | 582,390 |
| Total | $830,383 | $2,832,841 | $6,502,233 | $992,303 |

During the ten years preceding the sale of Norge, Borg-Warner spent the following amounts on capital improvements to fixed assets[3] in the Norge Division:

| Year | Fixed Assets Additions |
|---|---|
| 1958 | $ 134,690 |
| 1959 | 1,418,230 |
| 1960 | 1,020,077 |
| 1961 | 6,716,033[1] |
| 1962 | 1,591,163 |
| 1963 | 2,903,467 |
| 1964 | 3,884,681 |
| 1965 | 1,782,683 |
| 1966 | 1,043,888 |
| 1967 | 678,047 |
| 1968 (6 months) | 425,920 |

[1] This figure includes construction of the Fort Smith refrigerator plant.

## OPINION

Fedders and Borg-Warner made different allocations of the purchase price paid for Norge on their tax returns. Fedders allocated the purchase price to the individual assets according to their book values, with certain adjustments which it thought more accurately reflected market values. Fedders allocated no part of the purchase price to intangible assets. Borg-Warner independently determined the fair market value of each asset and allocated the sales proceeds to the individual assets according to their relative fair market values. According to its determination, the total fair market value of the Norge assets was $113,229,231 and the fair market value of the intangible assets

[3] The record does not indicate how much Borg-Warner spent for retooling in these years. Such amounts are included in the amounts shown for Fedders under "Jigs and Dies." This fact must be considered when comparing figures.

was $45,000,000. Allocating the sales proceeds on this basis, it attributed $22,171,068 to intangible assets.[4]

Respondent determined deficiencies against both parties to the transaction, using Fedders' allocation to determine the deficiency against Borg-Warner and using Borg-Warner's allocation to determine the deficiency against Fedders.[5] He takes the position of a stakeholder, leaving it to the Court to resolve the differences between the parties in accordance with the well established rule that, upon the sale of a going business, the purchase price must be allocated among the individual assets to determine the seller's gain or loss on each asset and to establish the buyer's basis in each asset. *Watson v. Commissioner*, 345 U.S. 544, 552 (1953); *Williams v. McGowan*, 152 F.2d 570, 572 (2d Cir. 1945); *F & D Rentals, Inc. v. Commissioner*, 44 T.C. 335, 346 (1965), affd. 365 F.2d 34 (7th Cir. 1966). See section 1.334-1(c)(4)(viii), Income Tax Regs.

Initially, we must dispose of a procedural issue raised by Fedders. In the notice of deficiency sent to Fedders, respondent allocated a portion of the purchase price to "goodwill." Fedders contends that some intangible assets, such as going-concern value, are distinct from goodwill and that respondent has the

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[4] In making this allocation, Borg-Warner valued the sales proceeds at $55,790,307. Subsequently, Borg-Warner and respondent agreed that the total sales proceeds equals $56,550,507.

[5] In determining the deficiency against Fedders, respondent determined that the total consideration paid was $58,169,043, consisting of the net book value of $45,213,255 plus liabilities of $12,955,788. See *R.M. Smith, Inc. v. Commissioner*, 69 T.C. 317, 321-322 (1977), affd. 591 F.2d 248 (3d Cir. 1979). We are unable to independently determine from the record the amount of liabilities assumed. However, since Borg-Warner requested as a finding of fact that the liabilities assumed were in the amount of $12,955,788 (the amount used by respondent in the deficiency notice to Fedders) and neither respondent nor Fedders objected to this proposed finding, we assume that it is correct.

Fedders' argument that respondent used Borg-Warner's tax basis in making the allocation in its deficiency notice to Fedders is not supported by the facts. Borg-Warner's tax basis in the Norge assets was $62,325,364.

burden of proof with respect to the existence of any intangibles that are not encompassed by the term "goodwill."

When respondent raises a new matter that was not included in his notice of deficiency to the taxpayer he has the burden of proof with respect to that matter. See Rule 142(a), Tax Court Rules of Practice and Procedure. A new theory or reason that is presented to sustain a deficiency is treated as "new matter" when it increases the amount of the deficiency, requires presentation of different evidence, or is inconsistent with resondent's original determination. *Estate of Emerson v. Commissioner*, 67 T.C. 612, 620 (1977); *Florists' Transworld Delivery Assn. v. Commissioner*, 67 T.C. 333, 348 (1976); *Sanderling, Inc. v. Commissioner*, 66 T.C. 743, 757-758 (1976), affd. 571 F.2d 174 (3d Cir. 1978). However, when respondent has merely clarified or developed his original determination without raising new factual issues or altering the amount of the deficiency, the burden of proof does not shift to him. *Estate of Jayne v. Commissioner*, 61 T.C. 744, 748-749 (1974); *McSpadden v. Commissioner*, 50 T.C. 478, 493 (1968).

We recognize that some cases distinguish going-concern value from goodwill. See, e.g., *VGS Corp. v. Commissioner*, 68 T.C. 563, 591 (1977). But, there are also cases that find it unnecessary to make such a distinction. See *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 685 (5th Cir. 1971); *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223, 234-235 (1975). Goodwill has been recognized as a broad and elusive concept. The Supreme Court, in *Menendez v. Holt*, 128 U.S. 514, 522 (1888), defined goodwill as—

> every positive advantage that has been acquired by the old firm in the progress of its business, whether connected with the premises in which the business was previously carried on, or with the name of the late firm, or with any other matter carrying with it the benefit of the business.***

See also, *In re Brown*, 242 N.Y. 1, 150 N.E. 581 (1926) ("any privilege that gives a reasonable expectancy of preference in the race of competition"). This Court has also on occasion taken a

broad view of goodwill, stating that it "may arise from: (1) the mere assembly of the various elements of a business, workers, customers, etc., (2) good reputation, customers' buying habits, (3) list of customers and their needs, (4) brand name, (5) secret processes, and (6) other intangibles affecting earnings." *Staab v. Commissioner*, 20 T.C. 834, 840 (1953).

Whatever may be the substantive ramification of the difference between "goodwill" and "going-concern value," we think it clear that, in a procedural context, no new factual issues can be said to have been raised by arguments made under the rubric of respondent's use of the term "goodwill" with respect to going-concern value, brand name, distributorships, or other intangible values. Moreover, Fedders has been represented by competent counsel throughout this proceeding and there is no evidence that they were misled by respondent's notice of deficiency. Accordingly, we hold that no new matters have been raised by respondent and the burden of proof does not shift to him. Nevertheless, we are constrained to note that our decision herein would be the same, regardless of which party has the burden of proof. See pp. 65-66, *infra*.

We turn now to the substantive dispute between the parties. Fedders claims that it acquired certain assets of the Norge Division, that these assets were valued by the parties at their book values through arms's length negotiations, and that the intangible assets were valued at zero.[6] According to Fedders, Borg-Warner is now attempting to vary the terms of their agreement in contravention of the rule in *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), vacating and remanding 44 T.C. 549 (1965), that a party to a contract may challenge the tax consequences of his agreement only if he proves it is unenforceable against the other party to the contract because of mistake, undue influence, fraud, duress, etc. 378 F.2d at 775. In the alternative, Fedders argues that the purchase price should be allocated according to the negotiated book values because

[6] For a similar argument, see *Concord Control, Inc. v. Commissioner*, T.C. Memo., 1976-301.

that allocation is in accord with economic reality. Borg-Warner contends that the purchase price was a lump-sum payment for Norge as a going business, that no allocation of the price among specific assets was made, and that it is the task of this Court to make such an allocation. We think that Borg-Warner has framed the issue correctly.

It is clear that Fedders did not acquire certain assets of the Norge Division, but rather acquired the entire business as a going concern, with certain minor exclusions. The preamble of the contract stated that the seller desires to sell and the buyer desires to purchase the "business and its assets, including the good will of said business as a going concern." In accordance with the contract, Borg-Warner retained certain assets (see pp. 19-20, *supra*) and assigned to Fedders specifically enumerated assets and

> All other assets and rights of every kind and nature, real or personal, tangible or intangible, which are owned by and used by Seller [Borg-Warner] solely in connection with the business of Division [Norge], whether or not such assets are reflected in the Pro Forma Balance Sheet or are to be reflected in the Audited Balance Sheet***

Moreover, the Pro Forma Balance Sheet, which set forth all assets that were to be included in the Audited Balance Sheet, included patents and goodwill. The fact that a few assets were excluded from the transaction does not impair the going-concern nature of the business. See *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d at 679-680.

It is also clear that the parties did not allocate the price among the individual assets in their agreement. The sales contract is written in terms of a purchase price equal to net book value and makes no reference whatsoever to allocation of that price. See *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d at 679. That no allocation was intended is evidenced from the fact that the parties agreed upon the final purchase price without resolving their dispute over the book value of certain assets. We do

not question the testimony of the current president of Fedders that Fedders refused to pay anything for intangibles. But, we think this is merely evidence that Fedders would not pay a premium over net book value and not that the parties agreed to an allocation of the purchase price. See *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d at 680-682.

Because the parties did not allocate the price among the separate assets in their contract, the rule of *Commissioner v. Danielson, supra*, is inapplicable.[7] See *Shepard v. Commissioner*, 57 T.C. 600, 610-611 (1972), revd. by unpublished order 481 F.2d 1399 (3d Cir. 1973).

Turning to the task of allocating the purchase price among the individual assets, we begin by determining the value of the intangible assets. This is a question of fact (see *Wilmot Fleming Engineering Co. v. Commissioner*, 65 T.C. 847, 861 (1976)) that cannot by determined on the basis of any simplistic rule or formula. In reaching our conclusion, we have studied the witnesses' testimony and the exhibits with great care. We have considered the factors that might bear on a purchaser's decision to acquire a company and on his determination of the price he is willing to pay, including the history of Norge, its earnings, its sales, its place in the white goods industry, the nature of that industry, and its likely future. While no useful purpose would be served by a detailed explication of our reasoning, the major factors bearing on our decision are discussed below.

Norge's poor history of earnings is an important fact that tends to show that the Norge intangibles were worth considerably less than Borg-Warner claims. The concepts of goodwill and going-concern value are associated with the expectation of

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[7] Even if the parties had made an allocation, we think that the *Danielson* rule would in any event be inapplicable because both parties are before the Court. *Freeport Transport, Inc. v. Commissioner*, 63 T.C. 107, 115-116 (1974). We do not think that the applicability of *Danielson* depends on whether the respondent takes the role of an active or passive stakeholder, as Fedders contends. Rather, we think the critical point is whether respondent chooses to rely on the parties' agreement. See *Freeport Transport, Inc. v. Commissioner, supra* at 118 (Tannenwald, *J.*, concurring).

continued profits notwithstanding a change in ownership. Thus, goodwill is frequently defined as the expectation of continuing excess earning capacity and some competitive advantage or continued patronage. E.g., *VGS Corp. v. Commissioner*, 68 T.C. at 590; *Wilmot Fleming Engineering Co. v. Commissioner*, *supra* at 861. Similarly, going-concern value is defined in terms of the ability to generate income. In *VGS Corp.*, we said (p. 592) that the theory of going-concern value is—

> that even in the absence of goodwill, excess earning capacity, and the like, the ability of a business to continue to function and generate income without interruption as a consequence of the change in ownership, is a vital part of the value of a going concern. *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 685 (5th Cir. 1971); *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223, 235 (1975).

Moreover, we are mindful that the purpose of a business is, by definition, to make a profit. Cf. *Godfrey v. Commissioner*, 335 F.2d 82, 84 (6th Cir. 1964), affg. T.C. Memo. 1963-1; *Hirsch v. Commissioner*, 315 F.2d 731, 736 (9th Cir. 1963), affg. T.C. Memo. 1961-256.

Accordingly, in reaching our conclusion herein, we have placed considerable weight on Norge's poor earnings history. We have not overlooked Norge's profitability from 1952 to 1962, but we think its success during this period was largely attributable to the outstanding talent of Judson Sayre. The managerial ability, experience, and personal attributes of an individual are not transferable goodwill.[8] *Wilmot Fleming Engineering Co. v. Commissioner*, *supra* at 861; *Estate of Gannon v. Commissioner*, 21 T.C. 1073, 1081 (1954); *MacDonald v. Commissioner*, 3 T.C. 720, 727 (1944). We have also considered the fact that, after a period of losses following Sayre's retirement, Norge began to earn a profit again before its sale to Fedders. Further, we recognize that Norge's losses were due in part to two specific problems, namely, the Norge Villages and the Fort Smith plant. Nevertheless, the picture of Norge that emerges from the record

[8] However, the contractual right to an individual's services, if sold as part of a going-concern, may be an intangible asset. See *United States v. Cornish*, 348 F.2d 175, 182 (9th Cir. 1965).

is a company that, since World War II, was unable consistently to earn a profit except under the exceptional managerial leadership of Judson Sayre.

On the other hand, the fact that Norge was not consistently profitable is not dispositive of the issue. Just as high earnings alone do not prove the existence of goodwill, *Wilmot Fleming Engineering Co. v. Commissioner*, *supra* at 860-861; *Carty v. Commissioner*, 38 T.C. 46, 58 (1962), lack of profitability does not in and of itself prove the absence of any intangible value.[9] *Buddy Schoellkopf Products, Inc. v. Commissioner*, 65 T.C. 640, 645, 647-648 (1975); *Computing & Software, Inc. v. Commissioner*, 64 T.C. at 235; *C.F. Hovey Co. v. Commissioner*, 4 B.T.A. 175, 177 (1926).

Concededly, Norge had no goodwill in the sense of excess earnings capacity and Borg-Warner does not contend otherwise. Nor do we think that Norge had much going-concern value in the sense of an inherent capacity to continue generating a profit. To the contrary, its ability to earn a profit at all was tenuous. The changes that Fedders made after its acquisition of Norge in personnel, plant, product lines, and distribution support our conclusion. No doubt, as Borg-Warner contends, some of these changes merely reflect differences between Borg-Warner's and Fedders' management in business policy and philosophy. The magnitude and number of changes, however, undermine this argument. If Norge had been a more profitable operation, we doubt that Fedders would have been so quick to make changes. In addition, we have been influenced by Borg-Warner's own recognition of the need to make substantial changes by either investing more capital in Norge or merging with another white goods company.

The fact that the business was sold at net book value and no dollar value was ever assigned to intangibles in the parties' negotiations also tends to show the Norge intangibles had little value. See *Wilmot Fleming Engineering Co. v. Commissioner*, 65 T.C. at 860.

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[9] See *Pensacola Greyhound Racing, Inc. v. Commissioner*, T.C. Memo. 1973-225, affd. in unpublished opinion (5th Cir. 1974).

Notwithstanding the factors discussed above, we are convinced that the Norge name was valuable. Fedders itself took this position in materials prepared for its lenders, in public statements after the acquisition, and in statements to securities analysts. More importantly, Fedders used the Norge name extensively.[10] See *Winn-Dixie Montgomery Inc. v. United States*, 444 F.2d at 681; *Computing & Software, Inc. v. Commissioner*, 64 T.C. at 235. These statements and actions, together with the extensive evidence of the importance of a brand name in the white goods industry, are compelling evidence that the Norge name had value, one aspect of which at least was to accelerate Fedders' ability to enter the field more effectively than if it had had to establish a new name from scratch. We conclude that, to the extent that the Norge Division had any goodwill or going-concern value (such as its distributorship system), it emanated from and was inextricably intertwined with the name Norge.[11]

There are, as in most cases, other factors that favor the opposite conclusion. Norge's market share was small and declining and its ratings in consumer publications showed a downward trend, a factor which would tend to reduce the value of the Norge name. Further, a large portion of its sales were to companies that sold Norge products under their own labels. We think that quality and price, not brand name, would be the important considerations in such sales. We have given careful consideration to these factors and have taken them into account in determining the value of the Norge name.

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[10] See *R. M. Smith, Inc. v. Commissioner*, T.C. Memo. 1977-23.

[11] We find it unnecessary to draw fine distinctions between goodwill, going-concern value, tradename, and other intangibles because Fedders makes no claim that it acquired any valuable intangible assets that are amortizable. Compare *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1247 (5th Cir. 1973); *Union Bankers Insurance Co. v. Commissioner*, 64 T.C. 807, 831-832 (1975). But method of allocation varies by Bbbbb over conversion.

We turn now to the task of placing a value on the Norge name. Fedders, adhering to its position that the Norge name had no value, introduced no evidence on this aspect of the issue. Borg-Warner sought to prove the value of the Norge name through expert testimony. Glenn S. Olinger, a businessman with over 20 years of experience in the appliance industry, testified that a purchaser of a household appliance business would require a discount of ⅛ to ½ of the book value if he were not acquiring the brand name of the business. Because of the general nature of Mr. Olinger's testimony, it is of little assistance in valuing the Norge name. His conclusion is based on his knowledge of negotiations regarding a contemplated sale of Ford's refrigerator business without the name Philco, but the evidence provides no basis for comparison of the Philco and Norge names. Moreover, Mr. Olinger had almost no knowledge of Norge's operations at the time of Fedders' acquisition.

Borg-Warner also presented evidence of the cost of creating consumer awareness of a new brand name. Mr. Olinger testified that in 1968 it would cost $8–$10 million a year for several years to acquire consumer recognition of a new name. The record does not reveal the foundation of his opinion (other than his general experience) and, therefore, his opinion is difficult to evaluate. On balance, we are unable to accord it much weight.

On the other hand, the testimony of Richard Larko, an advertising executive, was based on a written study which was admitted into evidence. According to his study, an expenditure of approximately $18 million over five years would be required to establish consumer awareness of a brand name by 1968, the year in which Fedders acquired the Norge name by purchase. He projects high expenditures in the first two years ($5,400,000 in year one, $3,750,000 in year two) followed by an expenditure of $3,000,000 in each of the last three years, a figure somewhat higher than the average of $2,067,000 expended each year by the top ten (see p. 27, *supra*). We find that Mr. Larko's study is carefully reasoned and reliable. However, in basing an argument on this study, Borg-Warner failed to take into account the fact that there is a cost involved in maintaining the favorable impact

of any trade name. Thus, we think that the relevant figure is not the cost of establishing a new name, as argued by Borg-Warner, but rather is the amount by which the cost of establishing a new name exceeds the cost of maintaining an existing name. The difference between Mr. Larko's estimate of the cost of establishing a new name ($18 million over five years) and the average expenditures for traceable advertising by the top ten companies over five years ($2,067,000 × 5 = $10,335,000) is $7,665,000. Moreover, since the Norge name had some negative attributes, Mr. Larko's figure should be further reduced to account for the expense that a purchaser would have to incur to try to improve the Norge image. Taking all these factors into account, as well as the factors we considered in determining whether any value at all attached to the Norge name (see p. 50-51, *supra*), we conclude that the fair market value of the Norge name and any goodwill or going-concern value that emanated from the name was $4.5 million. Cf. *Buddy Schoellkopf Products, Inc. v. Commissioner*, 65 T.C. 640 (1975). We think it is important to note, however, that, although we have placed substantial emphasis on the estimated cost of establishing a trade name in arriving at a value for the Norge name (cf. *Richard S. Miller & Sons v. United States*, 210 Ct. Cl. 431, 447, 537 F.2d 446, 456 (1976)), we are not adopting any firm principle regarding the use of such analysis in other cases. Each situation will have its own variants and we have simply adopted this approach as providing the most probative evidence based upon the particular facts and circumstances revealed by the record herein.

Having determined that the fair market value of the Norge intangibles was $4.5 million, we turn now to the question of how to allocate the purchase price among the Norge assets. The rule is simply stated: where a lump sum is paid for a going business, after valuing cash and cash equivalents at their face values, the balance of the purchase price is allocated among the remaining individual assets according to their relative fair market values. *Victor Meat Co. v. Commissioner*, 52 T.C. 929, 931 (1969); *F. & D. Rentals, Inc. v. Commissioner*, 44 T.C. at 346.

Fedders argues that if the intangibles have any value, the proper adjustment to account for such value is to the cost basis of the fixed assets and not to the current assets. It offered no independent evidence of the fair market value of either the fixed assets or the current assets. As support for its position, Fedders relies on the testimony of its expert, Donald Kehoe, a certified public accountant, and on case law, particularly *VGS Corp. v. Commissioner*, 68 T.C. 563 (1977), and *Northern Natural Gas Co. v. United States*, 470 F.2d 1107 (8th Cir. 1973).

We think neither the expert testimony nor the case law requires the result that Fedders seeks.

Mr. Kehoe cited Accounting Principles Board Opinion No. 16 (August, 1970) as the authority for his opinion. We have read this opinion and find it is silent on the precise issue before us. Yet, even if this were the rule for purposes of financial accounting, we would not be bound by it. *Thor Power Tool Co. v. Commissioner*, 439 U.S. ___ (Jan. 1979).

With respect to the cases cited by Fedders, it is true that in those cases, the court stated that the amount of the lump-sum purchase price attributable to going-concern value must be excluded from the values the taxpayer assigned to depreciable assets. *VGS Corp. v. Commissioner, supra* at 592; *Northern Natural Gas Co. v. United States, supra* at 1110. However, Fedders overlooks the fact that the courts' statements were made in the context of the Commissioner's assertion that the fixed assets were *overvalued*, thus reflecting enhancement by going-concern value, and that the Court agreed with this assertion. The value of the current assets was not at issue. Fedders has not argued that the book value of the fixed assets is inflated. To the contrary, Fedders argues that the book value is a price negotiated at arm's length and, thus, equal to fair market value. Moreover, because book values represent cost less depreciation, we are inclined to doubt that they reflect enhancement by the value of intangibles.

Although Fedders does not state its position in terms of cash equivalency, its argument is essentially that current assets should be treated as cash equivalents. Where the facts warranted such

treatment, prepaid insurance and other prepaid expenses have been treated as cash equivalents, see *Victor Meat Co. v. Commissioner, supra* at 933, and accounts receivable guaranteed by the seller have been treated as cash equivalents, *Bixby v. Commissioner*, 58 T.C. 757, 786 (1972). But, as a general rule, current assets are not cash equivalents. See *Victor Meat Co. v. Commissioner, supra*; *Boise Cascade Corp. v. United States*, 288 F. Supp. 770 (S.D. Idaho 1968).

Borg-Warner discerns three separate intangible assets in Norge: (1) going-concern value; (2) brand name; and (3) distribution system. It then reduces the book value of the tangible assets that are enhanced by the separate intangible assets by the amount attributable to the intangibles, although as our subsequent discussion will reveal, Borg-Warner appears to recognize that these elements are not totally unrelated but tend to coalesce under the umbrella of the Norge name—a point of view which is consistent with our own previously articulated position. For the reasons stated below, we think Borg-Warner's approach is without merit.

Borg-Warner approaches the allocation of going-concern value in a manner similar to that of Fedders. Citing cases which state that going-concern must be valued separately from depreciable assets and relying on Mr. Olinger's testimony that an appliance company without a brand name would sell at a discount of ⅓ to ½, Borg-Warner bootstraps itself to the conclusion that ⅓ to ½ of the book value of Norge's land, plant, and equipment represents going-concern value. Like Fedders, however, Borg-Warner has presented no evidence as to the fair market value of the fixed assets but, rather, assumes, without proving, that the book value of the fixed assets reflects enhancement by going-concern value. Another defect in Borg-Warner's approach is that it relies on Mr. Olinger's testimony, which dealt with the value of a brand name, for its argument as to going-concern value, which it distinguishes from brand name.

Borg-Warner contends the inventory and accounts receivable are the assets that are most affected by the value of the brand name and distributorship system. It then argues that the fair market value of the accounts receivable and inventory is the

amount for which they could be sold without the Norge name and distributorship system. Its experts testified that the inventory could only be sold under these conditions at a discount of ⅓ to ½ off book value and that the accounts receivable could only be sold at a discount of 15 percent off book value. Borg-Warner attributes the difference between this amount and book value to the intangible assets. We think that Borg-Warner has applied the wrong standard of valuation.

The basic legal definition of fair market value is the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy or sell, and both being reasonably informed as to all relevant facts. See 10 Mertens, Law of Federal Income Taxation, sec. 59.01 (1976 rev.). When a business is sold as a package, its assets must be valued in that posture. *Kraft Foods Co. v. Commissioner*, 21 T.C. 513, 585 (1954), revd. on another issue 232 F.2d 118 (2d Cir. 1956). In the case of inventory, this means it must be valued on the theory that it may be sold to a hypothetical willing buyer having facilities equal to that of the seller for distributing it at retail. *Knapp King-Size Corp. v. United States*, 208 Ct. Cl. 533, 551-552, 527 F.2d 1392, 1401-1402 (1975).

Borg-Warner relies heavily on the testimony of witnesses as to the discount that would be necessary to sell the inventory without a brand name, i.e. they assumed a forced sale of the inventory on a liquidation basis, separate from the business of which it was a part and to a buyer who did not have an established market in which to sell it. We think such testimony is of minimal relevance herein because it ignores, as does Borg-Warner's argument based thereon, the economic reality of the sale to Fedders. Borg-Warner rejected the option of liquidating Norge because it would have incurred substantial losses on the sale of its inventory and accounts receivable. Instead, it chose to sell the Norge Division as a package and we think it can be inferred that, by choosing this option, it avoided the large losses that it would have suffered on liquidation. Because the valuation it seeks herein would result in large losses, it appears that such valuation is closer to the liquidation values than to the amount a

buyer would pay for inventory and receivables purchased as part of an entire business. That Borg-Warner's valuation does not reflect economic reality is further evidenced by the fact that it would result in large profits for Fedders and large losses for Borg-Warner. We cannot believe that Borg-Warner would sell its inventory and receivables to Fedders at such a discount if Fedders could obtain the same price for them that Borg-Warner could have obtained through normal market distribution. We conclude that Borg-Warner takes much too narrow a view of the proper method of valuing the inventory and receivables sold to Fedders. *Knapp King-Size Corp. v. United States, supra.*

*United States v. Cornish*, 348 F.2d 175 (9th Cir. 1965), upon which Borg-Warner relies for the proposition that the inventory must be valued at the price it would bring if sold without regard to the Norge name, is inapposite. In *Cornish*, the court refused to accept the taxpayer's valuation of timber on the basis of a "work back" or conversion formula. The formula began with estimated sales realization and subtracted expenses and anticipated profit. The court believed that this formula improperly took into account the prospect that the business would get more and better timber out of a given tree than most other sawmills, a prospect that was attributable to the sellers' unique skills and abilities. In reaching its decision, the court considered separately the past exercise and the future exercise of the sellers' skills and abilities. With respect to the past exercise of the sellers' skills and abilities, the court concluded that they were an inseparable part of the sawmills and were properly reflected in the valuation of the sawmills. For this reason, the court stated that the formula had the effect of valuing this element twice. With respect to the prospect that the sellers would exercise their skills and abilities in the future, the court held that this was an intangible asset, but that it had not been purchased by the buyers because the sellers were not contractually committed to devote their skills to the business. Therefore the court concluded that it was improper to include these skills and abilities in the valuation of the timber. We fail to see the relevance of *Cornish* to the instant case.

In *Jack Daniel Distillery v. United States*, 180 Ct. Cl. 308, 379 F.2d 569 (1967), the court held that it was proper, for purposes

of section 334(b)(2), to value unbottled Jack Daniel whiskey on the assumption that the purchaser was acquiring the right to use the Jack Daniel label. The court rejected the Commissioner's contention that the Jack Daniel name was an intangible asset that had to be separately valued because the court found that Jack Daniel acquired uniqueness during the distillation and leaching process prior to being placed in barrels to age and because, as a matter of commercial practice, the whiskey would not be sold at all without the right to use the Jack Daniel name. See *Heaven Hill Distilleries, Inc. v. United States*, 201 Ct. Cl. 423, 432-434, 476 F.2d 1327, 1333 (1973).

Borg-Warner argues at length that Norge appliances are not unique like Jack Daniel whiskey and that *Jack Daniel Distillery v. United States, supra*, is therefore not controlling. While we tend to agree with Borg-Warner's distinction, we do not think that it support the opposite inference which Borg-Warner seeks to draw from it to support its valuation of the Norge inventory at ⅔ of book value. As we have already pointed out, such a valuation applies the wrong standard because it is based on the assumption that the inventory is not sold as part of a package but rather to a buyer who has no established market in which to sell it. See pp. 59-60, *supra*. Moreover we note two further factors which support our conclusion that *Jack Daniel Distillery* is inapplicable: (1) the issue before the court, in that case, was a narrow one, i.e. limited to the valuation of *existing* unbottled whiskey and did not involve, as does the case before us, the valuation of a business sold as a package and the auxiliary right to use a trade name on goods to be manufactured and sold in the future and (2) there was no issue as to any inventory which might be available for sale under a private label as in the case herein, it being clear that the unbottled whiskey could, because of its uniqueness, only be marketed under the Jack Daniel name. Cf. *Bourjois, Inc. v. McGowan*, 85 F.2d 510 (2d Cir. 1936).

Having rejected Fedders' argument that the book values of the assets represent prices negotiated at arm's length for individual assets and having rejected Borg-Warner's evidence as irrelevant under the applicable standard for measuring fair market value, we are left with the task of allocating the purchase price

among the assets on the basis of a rather barren record. Respondent's position as a stakeholder does not shift the burden of proof. See *Wilmot Fleming Engineering Co. v. Commissioner*, 65 T.C. at 860; *Freeport Transport, Inc. v. Commissioner*, 63 T.C. 107, 116-117 (1974) (Dawson, *J.*, concurring), and cases cited thereat. Had we not found a value for intangibles, we think we technically would have been justified in sustaining each of respondent's determinations on the ground that both petitioners have failed to carry their burden of proof. However, we have found a value of $4.5 million for the intangibles of the Norge Division, i.e., the Norge name, and in any event we think such a disposition inappropriate for cases such as this where both parties are before us. See *Freeport Transport, Inc. v. Commissioner, supra* at 115. Accordingly, we proceed to allocate the purchase price as best we can on the basis of the record herein.

After careful consideration of the record, we conclude that the book values of the Norge assets are the best evidence of their fair market value.[12] We are well aware that book value does not

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[12] We note that there is evidence of the replacement value of the Norge plants in the record. However, neither party has relied on it as evidence of fair market value.

Because Borg-Warner and Fedders never agreed on the book value of each individual asset but rather compromised and agreed to a figure of $45,213,255 for the final purchase price, the record does not contain a balance sheet that reflects the final purchase price or its breakdown. Therefore, the parties are directed to use the book values shown on the balance sheet prepared by Peat, Marwick, Mitchell & Co. (the PMM balance sheet) (see p. 21, *supra*) as a starting point and to make the following adjustments to reflect the final terms of the sale. Since the liabilities assumed by Fedders amounted to $12,955,788 (see footnote 5, *supra*) and the parties agreed that $45,213,255 was the net book value of the Norge Division for purposes of determining the selling price, the aggregate book value of the assets is determined to be $58,169,043 ($45,213,255 plus $12,955,788). The aggregate book value of the assets shown on the PMM balance sheet is $61,913,788. The value of each asset shown on the PMM balance sheet is to be reduced by an amount determined by the following formula:

$$X = \frac{A}{B} \times C$$

In the formula, X equals the amount to be subtracted from a given asset (the "unknown"), A equals the value of a given asset as shown on the PMM balance sheet, B equals $61,913,788, the aggregate value of the assets as shown on the PMM balance sheet and C equals $3,744,745, the difference between

necessarily bear any relationship to fair market value, but book value is some evidence of fair market value and has been resorted to in the absence of other evidence. See *Bos Lines, Inc. v. Commissioner*, 354 F.2d 830, 839 (8th Cir. 1965), affg. T.C. Memo. 1965-71; *Blum v. Commissioner*, 5 T.C. 702, 709 (1945).

There is strong evidence that the parties thought that, in this case, book values did bear considerable relationship to fair market values: the fact that Norge was sold for its net book value, the fact that Fedders has steadfastly maintained that the book values represent negotiated fair market values, and the fact that Borg-Warner used book values as a starting point for its discounts (which we have rejected) and did not introduce any evidence of fair market value independent of book value. Moreover, under the terms of the sales contract, the book value of the inventory was to be determined at the lower of cost or market value. It is, by definition, equal to or less than Borg-Warner's investment and we think it is not unreasonable to infer that a buyer would be willing to pay this amount for the inventory as part of a going-concern. Similarly, we think that it is not unreasonable to infer that a buyer would be willing to pay book value, that is, face value less a reserve for bad debts, for accounts receivable acquired as part of a going business.

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the aggregate value of $61,913,788 shown in the PMM balance sheet and the aggregate value of $58,169,043 which reflects the final purchase price.

After determining the book value of each asset in accordance with the above directions, the purchase price is then to be allocated among the individual assets using the following formula:

$$Y = \frac{D}{E} \times F$$

In the formula, Y is the portion of the purchase price to be allocated to a given asset (the "unknown"), D is the fair market value of a given asset (for "goodwill" it is $4.5 million and for the other assets it is the book value adjusted in accordance with the directions above), E is the total fair market value of all assets ($58,169,043 plus $4,500,000 equals $62,669,043), and F is the total purchase price. (Borg-Warner and the respondent agreed that the total sales proceeds equals $56,550,507. Fedders was not a party to this agreement but as far as the record and briefs indicate, Fedders does not disagree with respondent's determination that, as to it, the purchase price paid by Fedders is $58,169,043, the sum of $45,213,255 and $12,955,788, the liabilities assumed by Fedders. See footnotes, 4, 5, *supra*).

At this point we are constrained to note that the issue involved herein has many of the qualities found in the usual valuation case. It therefore lacks the talismanic precision with which counsel for each of the parties has sought to imbue it and was clearly more susceptible of disposition by way of negotiation and settlement rather than being subjected to the judicial process with its concomitant inordinate expenditure of time, effort, and money by all concerned. See *Messing v. Commissioner*, 48 T.C. 502, 512 (1967). Indeed, the Court repeatedly sought to persuade the parties to pursue the settlement route, all to no avail. Accordingly, we have discharged the responsibility thrust upon us, carefully avoiding the blandishment of the parties to dissect each element with a surgical knife. Rather, we have carefully considered each of the elements discussed by the parties in the context of the entire record before us and weighed all of the facts and circumstances revealed herein.

Fedders argues that, if it did acquire any intangible assets of value, it abandoned those assets within the first year after the acquisition and is entitled to an abandonment loss under section 165(a). In making our determination as to the value of the Norge Division's intangible assets, we considered the substantial changes that Fedders made following the acquisition as evidence that Norge had little going-concern value as such and concluded that any intangible value that was transferred emanated from and was inextricably intertwined with the Norge name. See p. 49, *supra*. It is clear that Fedders did not abandon the Norge name. Accordingly, Fedders is not entitled to an abandonment loss.

Borg-Warner claims entitlement to an ordinary loss under section 165(g)(3) for its stock in Warren-Connolly Company, a wholly owned subsidiary whose sole activity was distribution of the Norge Division's products. Borg-Warner had a tax basis of $2,258,301 in the stock and valued it at $1,503,776 in its original allocation of the sales proceeds from Norge. In his deficiency notice to Borg-Warner, respondent used Fedders' allocation, which had allocated no part of the purchase price to Warren-Connolly stock. Borg-Warner accepted respondent's valuation of

the Warren-Connolly stock and attempts to capitalize on it by claiming a worthless stock deduction.

We think that the record does not support Borg-Warner's contention that its Warren-Connolly stock was worthless on the date of sale. The balance sheet that Peat, Marwick, Mitchell & Co. prepared, which was the subject of price negotiations and was, with certain adjustments, the basis upon which Fedders allocated the purchase price, was a combined balance sheet which reflected the assets of both Norge and Warren-Connolly. Thus, the fact that Fedders allocated no part of the purchase price to Warren-Connolly stock does not mean that it allocated no part of Warren-Connolly's assets. On the record herein, we have held that the book values of the separate assets are the best evidence of their fair market values and, as far as we can determine from the record, some of those assets belonged to Warren-Connolly. Thus, we conclude that Borg-Warner has failed to sustain its burden of proof that its stock in Warren-Connolly was worthless in 1968 and it is therefore not entitled to a worthless stock deduction.

To reflect the foregoing,

*Decisions will be entered under Rule 155.*

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FILED
AUG 17 1981
ALEXANDER L. STEVAS,
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No. 81-108

# In the Supreme Court of the United States

OCTOBER TERM, 1980

FEDDERS CORPORATION AND SUBSIDIARIES, PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT*

## MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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In this federal income tax case, petitioner seeks review of a determination that a portion of the purchase price it paid to acquire an ongoing business was allocable to the intangible assets of that business.

The pertinent facts may be summarized as follows: In 1968, petitioner purchased the Norge Division of the Borg-Warner Corporation (Pet. App. 5a). The agreement of sale assigned to petitioner various Norge assets, including intangible assets, but did not allocate the lump-sum purchase price among the assets (Pet. App. 27a). In computing its federal income taxes, petitioner allocated no part of the purchase price to the intangible assets (Pet. App. 23a).[1] On

[1]The allocation of purchase price has numerous tax consequences that arise primarily from the tax basis that is acquired in the various Norge assets, which in turn affects, for example, the gain to be realized upon the collection of the accounts receivable and the sale of the inventory, as well as the amount of depreciation that may be claimed on the depreciable assets.

audit, the Commissioner of Internal Revenue determined that more than $23 million of the purchase price was properly allocable to the intangibles (Pet. App. 23a-24a).[2]

In this proceeding brought by petitioner for redetermination of the ensuing deficiencies, the Tax Court found that petitioner had acquired intangibles valued at $4,500,000 in its purchase of Norge (Pet. App. 33a). The court ruled that, while petitioner had acquired no "goodwill" as that term is used to mean an intangible that comprises an excess earnings capacity, petitioner had nevertheless received an intangible of value in acquiring the Norge name, which it used extensively following the purchase (Pet. App. 30a-31a). The Tax Court determined the value of the Norge name by ascertaining the amount that it would cost to establish consumer awareness of a brand name and reducing this figure to reflect what would in any case have to be expended to maintain such a name and to reflect certain negative attributes of the Norge business (Pet. App. 32a-33a). The court of appeals affirmed (Pet. App. 1a).

1. The allocation of a portion of the purchase price to the Norge name by the decision below is correct, particularly in view of petitioner's continued use of the name and its own representations to the public as to the value of the Norge name. In any event, the allocation of a lump-sum purchase price among the various assets of a business is a factual

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[2]Borg-Warner had assigned approximately $22 million to the intangibles for its tax purposes and, in order to protect the revenue, the Commissioner of Internal Revenue issued Borg-Warner a notice of deficiency in which he determined that the intangibles had no value (Pet. App. 23a-24a). Borg-Warner's case was consolidated with that of petitioner in the Tax Court. Currently pending in the Seventh Circuit (Nos. 80-1818 and 80-1855) are Borg-Warner's appeal on an unrelated issue and the Commissioner's protective cross-appeal on the question presented in the petition in this case.

determination. See, *e.g.*, *R.M. Smith, Inc.* v. *Commissioner*, 591 F. 2d 248, 251 (3d Cir. 1979). There is accordingly no basis for further review of this determination. *Rudolph* v. *United States*, 370 U.S. 269, 270 (1962).

2. Contrary to petitioner's assertion (Pet. 5-8), the decision below does not conflict with *Concord Control, Inc.* v. *Commissioner*, 615 F. 2d 1153 (6th Cir. 1980), on the question whether excess earnings capacity must be present in order for there to be goodwill in a business. *Concord Control* held that there could be no goodwill absent an expectancy of continued patronage or a competitive advantage, and did not even discuss a need for the presence of excess earnings capacity. See also *Skilken* v. *Commissioner*, 420 F. 2d 266 (6th Cir. 1969). At all events, the courts below found that goodwill (as that term is used to mean an intangible comprising an excess earnings capacity) was not present, but that there was a distinct intangible value in the Norge name. Thus, this case is an inappropriate vehicle in which to establish the legal definition of goodwill for tax purposes.[3]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
*Solicitor General*

AUGUST 1981

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[3]The Court has discussed both the definition of goodwill and the value of a trade name in other contexts. See *Menendez* v. *Holt*, 128 U.S. 514, 521-522 (1888) (goodwill); *Friedman* v. *Rogers*, 440 U.S. 1, 11-16 (1979) (trade name).

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